annual reports for years 1994, 1995, and 1996 all of which contained the false and misleading financial information. These annual reports, in turn, induced the shareholder to continue to hold on to his or her stock. In January 1997, when the truth about the company is disclosed, the stock precipitously drops in value, and the shareholder experiences a corresponding loss as a result of his or her continuing to hold the stock in reliance upon these false financial representations. There can be no doubt that the shareholder experienced a loss as result of his or her reliance upon the fraudulent financial representations – the day before the disclosure of the truth he or she had holdings that were valued at $X and the day after the truth was disclosed the holdings were diminished to $X-T (where T equals the market adjusted value of the stock after taking into account the impact of the truth).[2]

Such facts state a *prima facie* claim for common law fraud. Misrepresentations, reliance, action taken in reliance upon the misrepresentations, injury and damage – a paradigm common law fraud claim. Moreover, by definition it is an action that is not seeking damages arising out of frauds made in connection with the purchase or sale of a security.

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[2] The above fact pattern is similar to one that occurred with Mercury Finance Company, a Wall Street darling stock that reported 48 quarters of ever increasing profits only to restate 3 years of financial reporting to reflect that it had, in fact, been losing money throughout those years. A holder action brought in that matter has been certified as a class action and, in fact, is an example of how such an action can be certified as a class and achieve procedural efficiencies for state courts while providing justice for defrauded shareholders. *See, Dloogatch v. Brincat*, 97CH8790, Circuit Court of Cook County, Illinois, Chancery Division, July 31, 2003 Memorandum Opinion and Order, Appendix at App. 1.

There is nothing novel or cutting edge about such a claim. Simply stated, a "holder" claim is a straightforward state law common law fraud or misrepresentation claim. It is brought on behalf of a shareholder who has been defrauded into ***retaining*** (as opposed to purchasing or selling) a security. It does not seek damages arising out of frauds perpetrated in connection with the purchase or sale of securities. Rather, the gravamen of the claim is that at some point in time after the shareholder acquired the securities in question, the shareholder was fraudulently induced to continue to hold the subject securities until such time as the truth became public. This is the paradigm "holder" claim.

Moreover, contrary to what some counsel and courts have assumed, a "holder" claim does not require proof of whether a shareholder was induced to refrain from selling his or her stock at some point in time. It is this phantom element that has given some courts and commentators pause. They posit that it will open up the possibility of manufactured intentions to sell. As a threshold matter, the possibility of manufactured testimony with respect to the intent to sell is no basis to extinguish an entire cause of action. Numerous civil disputes revolve around proof of a person's intent and in turn the proof is based upon oral testimony regarding the witness' intent. Countless defendants accused of fraud have testified that they did not intend to commit fraud only to be found liable for fraud.

Most important, however, is that proof of intention to sell at some prior point in time, while certainly an option, is not a required element of a "holder" claim. Rather, the

claim is a typical common law claim alleging that defendant's misrepresentations and plaintiff's reliance on same induced plaintiff to take an affirmative act – that of continuing to hold on to the subject securities, until the truth was disclosed and as a result plaintiff was damaged when the disclosure of the truth caused the stock to drop in value.

Likewise, as this Court may have already seen in its review of the most recent lower court decisions dealing with "holder" claims, there is some confusion both within the bar and the bench as to what is a "holder" claim. Section 10(b) claimants purchased their securities and then continued to hold them until the fraud was disclosed. As a result, some cases, which are really purchaser fraud actions, have been pled as "holder" claims on behalf of shareholders who purchased their stock when the frauds were occurring and thus could have brought timely federal securities fraud actions.

NASCAT and AARP respectfully submit that such class actions are preempted by SLUSA and we have no problem with the proposition that SLUSA preempts state law based class actions on behalf of persons who purchased their securities within three years of the disclosure of the fraud, whether the case is styled as a holder/purchaser action or as a holder action. Such persons had valid Section 10(b) claims and were precisely the sort of state law class actions that Congress intended to prohibit and thus preempt: State law class actions brought on behalf of classes that include persons who had valid purchaser or seller claims under Section 10(b) of the 1934 Act.

There is a "hybrid" action, when purchaser claimants and holder claimants are lumped into one class of state law fraud claimants, which should also be preempted under SLUSA to the extent that plaintiffs insert or include purchaser claims in the class. Where, however, a class action is brought on behalf of investors who acquired their securities before the commencement of the actionable Section 10(b) fraud,[3] and the action is strictly limited to claims for damages arising from these investors being fraudulently induced to continue to hold on to their securities, such an action is not and should not be preempted under SLUSA. *See, e.g., Gordon v. Buntrock*, 2000 WL 556763,*4 (N.D. Ill. April 28, 2000).

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[3] The Second Circuit appears to hold that only "holder" claimants who acquired their shares prior to the commencement of the scheme to defraud can avoid the reach of SLUSA. In its view, if one bringing a "holder" claim purchased the security in question at a time when the frauds were alleged to have been occurring, even though it was over three years prior to the discovery of the fraud, any such claims brought as a class action should be preempted under SLUSA. NASCAT and AARP respectfully submit that this is the only error in the Second Circuit's approach. As discussed in greater detail below, SLUSA was intended to bar class action claims that could have been brought in federal court from being brought in state courts. If a defrauded investor has a potential Section 10(b) claim that is barred due to the three-year statute of limitations, this should not preclude her from pursuing, on a class basis, a separate and independent holder claim. The two claims are entirely distinct; indeed, they have entirely different elements and involve entirely different damages. In fact, it would work a severe injustice if investors who were the victims of a fraud that spanned five years were barred from seeking any recovery whatever merely because the perpetrators of the fraud were able to cover their tracks for a period beyond the three-year federal statute of limitations. Again, in the absence of Congress's clearly expressed intention that such claims should be preempted, it is respectfully submitted that these claims are not within the ambit of SLUSA.

II. History of Holder Claims

A. Pre 1933 and 1934 Acts

The states traditionally regulated securities fraud through common law torts such as fraud and negligent misrepresentation, stockholder derivative suits, and blue sky legislation. *See* Joshua D. Ratner, *Stockholders' Holding Claim Class Actions Under State Law After the Uniform Standards Act of 1998*, 68 U. Chi. L. Rev. 1035, 1037 (2001) (hereinafter, "Ratner *Stockholders' Holding Claims*"). From early on, most states that considered the issue recognized "holder claims" – *i.e.*, claims based on allegations that misrepresentations induced forbearance from selling stock. *See, e.g., David v. Belmont,* 291 Mass. 450, 197 N.E. 83 (1935) (alleging fraud inducing retention of stock shareholder would otherwise have sold); *Fottler v. Moseley,* 179 Mass. 295, 60 N.E. 788 (1901) (holding plaintiff stated claim for fraud against broker whose misrepresentations induced him to refrain from selling stock); *Duffy v. Smith,* 28 Vroom 679, 57 N.J.L. 679, 32 A. 371 (1895) (plaintiff fraudulently induced to buy stock could recover for period of retaining stock in reliance on same misrepresentation); *Continental Insurance Co. v. Mercadante*, 222 A.D. 181, 183-84, 225 N.Y.S. 488, 490-91 (1927) (considering claim for "fraud in inducing, not purchase of the bonds, but their retention after purchase," and holding that "plaintiffs cannot be denied redress because their conduct was inaction, rather than action").[4] *See also, Rothmiller v. Stein*, 98 Sickels 581, 38 N.E. 718,

[4] It should also be noted that what might be perceived as inaction (*e.g.*, not selling the stock) is actually an affirmative act that has been induced by the fraud – that act being the continued holding and retention of the stock.

719 (N.Y. 1894) (rejecting argument that plaintiff failed to state a claim based on allegations that he refrained from selling his stock based on defendant's misrepresentations); *Gutman v. Howard Savings Bank*, 748 F. Supp. 254, 264 (D.N.J. 1990) (holding that inaction induced by defendants' representations can establish the element of reliance in a common law securities fraud claim); *see also Small v. Fritz Companies, Inc.*, 30 Cal. 4th 167, 132 Cal. Rptr. 2d 490, 65 P.3d 1255 (2003).

Congress enacted the first federal laws regulating securities in the early 1930's in response to the stock market crash of 1929. *See* Ratner, *Stockholders' Holding Claim*, 68 Chi. L. Rev. at 1042. Congress passed the 1933 Act and the 1934 Act because the states had been ineffective in regulating nationally traded securities. *Id.* at 1042 (citing Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 Cornell L. Rev. 1, 24-25 (1998) (hereinafter Painter, *Responding to a False Alarm*) (noting that states were ineffective as the sole regulators of nationally traded securities because of state securities commissioners' inability to extend their authority across state lines). Despite Congress' concerns, each Act explicitly allowed concurrent securities regulation by the states. *See* Ratner, *Stockholders' Holding Claim*, (citing Painter, *Responding to a False Alarm*, 84 Cornell L. Rev. at 24-25 (noting that Section 18 of the 1933 Act did not affect the jurisdiction of state securities commissions and bestowed concurrent state and federal court jurisdiction and that while the 1934 Act gave federal courts exclusive jurisdiction over claims under that statute, Section 28(a) specifically protected blue sky laws from federal preemption). *See also* 15 U.S.C. § 77r (1933 Act's provision granting concurrent

jurisdiction); 15 U.S.C. § 78bb(a) (1934 Act's provision granting concurrent jurisdiction).

Section 10(b) of the 1934 Act enabled the SEC to enact rules and regulations regarding the use of manipulative and deceptive devices in relation to the purchase or sale of securities. 15 U.S.C. § 78j(b); *see Basic Inc. v. Levinson*, 485 U.S. 224, 230 (1988). Among other things, the 1934 Act included extensive disclosure requirements. *Basic*, 485 U.S. at 230. Under the authority granted by the 1934 Act, in 1942 the SEC promulgated a regulation making it

> unlawful for any person . . . (a) [t]o employ any device, scheme or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, . . . not misleading, or (c) [t]o engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the *purchase or sale* of any security.

17 C.F.R. § 240.10b-5 (emphasis added).

Following the enactment of the 1933 and 1934 Acts, it became apparent that private suits were important to supplement government enforcement actions. Ratner, *Stockholders' Holding Claims*, 68 U. Chi. L. Rev. at 1043. In response to this acknowledged need, the lower federal courts found an implied (or inferred a) private right of action to enforce Section 10(b) of the 1934 Act and SEC Rule 10b-5, and this Court endorsed this view in 1988. Ratner, *Stockholders' Holding Claim*, 68 U. Chi. L. Rev. at 1043; *Basic*, 485 U.S. at 230-31. In *Birnbaum v. Newport*

Steel Corp., 193 F.2d 461, 463 (2d Cir. 1952), the Second Circuit interpreted SEC Rule 10b-5 as aimed only at "'a fraud perpetrated upon the purchaser or seller' of securities and as having no relation to breaches of fiduciary duty by corporate insiders resulting in fraud upon those who were not purchasers or sellers." The *Birnbaum* court's interpretation of Rule 10b-5 barred holder's actions under that rule.

In 1975, this Court agreed that Rule 10b-5 did not permit holder actions. *Blue Chip Stamps*, 421 U.S. at 733, 749. This Court recognized, however, that completely barring holders' actions would result in injustice by denying relief to victims of fraud. The Court concluded that because its decision was limited to actions under Rule 10b-5, such injustice would not occur because defrauded stockholders still have a remedy in state court. As this Court stated:

> A great majority of the many commentators on the issue before us have taken the view that the *Birnbaum* limitation on the plaintiff class in a Rule 10b-5 action for damages is an arbitrary restriction which unreasonably prevents some deserving plaintiffs from recovering damages which have in fact been caused by violations of Rule 10b-5. . . . We have no doubt that this is indeed a disadvantage of the *Birnbaum* rule, and if it had no countervailing advantages it would be undesirable as a matter of policy. . . .

Blue Chip Stamps, 421 U.S. at 738-39. This Court further observed:

> Obviously this disadvantage is attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law. *Cf.* § 28

> of the 1934 Act, 15 U.S.C. § 78bb. *See Iroquois Industries, Inc. v. Syracuse China Corp.*, 417 F.2d 963, 969 (C.A.2 1969), *cert. denied*, 399 U.S. 909, 90 S.Ct. 2199, 26 L.Ed.2d 561 (1970). Thus, for example, in *Birnbaum* itself, while the plaintiffs found themselves without federal remedies, the conduct alleged as the gravamen of the federal complaint later provided the basis for recovery in a cause of action based on state law. *See* 3 L. Loss, Securities Regulation 1469 (2d ed. 1961). And in the immediate case, respondent has filed a state-court class action held in abeyance pending the outcome of this suit. *Manor Drug Stores v. Blue Chip Stamps*, No. C-5652 (Superior Court, County of Los Angeles, Cal.).

Id. at 739 n.9.

In short, as this Court recognized in *Blue Chip Stamps*, while there may have been policy reasons for limiting federal claims to purchasers and sellers, it would be unjust to deprive wronged stockholders who are not sellers or buyers a remedy; and that injustice is only avoided if such stockholders can maintain a lawsuit or retain a remedy in state court.

B. Post *Blue Chip Stamps*

Subsequent to *Blue Chip Stamps* "holder" claims slid into what might be described as a dormant period due to reasons unrelated to any federal law concerns. The leading state Supreme Court issued a series of decisions that created ambiguity as to whether a "holder" claim could be brought as a "direct" claim or was, in fact, a "derivative"

claim. *Cf. Lipton v. News Intern., PLC*, 514 A. 2d 1075, 1078 (Del. 1986) (adopting "special injury" test), *with Kramer v. Western Pacific Industries, Inc.*, 546 A. 2d 348 (Del. 1988) (applying "nature of the wrong" test). For the most part, other state courts, following the Delaware Supreme Court's lead, incorporated this ambiguous line of cases into their corporate laws. *See, e.g., Loewen v. Galligan*, 130 Or. App. 222, 228-29, 882 P.2d 104, 111-12 (Or. App. 1994).[5]

This ambiguity, however, was resolved by the Delaware Supreme Court in a series of decisions starting with *Malone v. Brincat*, 722 A. 2d 5 (Del. 1998). In that case, a class action was brought on behalf of Mercury Finance shareholders seeking to recover damages arising out of a financial fraud that spanned more than three years. *Id.* at 7. The lower court had dismissed the action with prejudice as being derivative. The Delaware Supreme Court reversed and remanded, holding that a valid claim for damages arising out of fraudulent financial reporting could be brought by shareholders as a "direct" claim in their capacity as shareholders.[6] *Id.* at 14. Subsequently, in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A. 2d 1031, 1037 (Del. 2004) the Delaware Supreme Court rejected the "special injury" test and thus cleared the way for direct claims to be brought on behalf of shareholders for frauds whose disclosure thereafter caused a diminution in the value of their securities. In a similar fashion, the

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[5] The confusion arose from an initial formulation that held that any conduct that caused a diminution in value of the stock as to all shareholders as a whole was deemed to be a derivative claim. *Id.*

[6] *Malone* was a related case to the previously cited *Dloogatch v. Brincat* in which a class of holder claimants was certified.

Supreme Court of California also recognized that holder actions were valid and could be brought under California law. *See Small*, 39 Cal. 4th at 176, 132 Cal. Rptr. 2d at 496, 65 P.3d at 1260 (2003).

III. State Courts Should Be Allowed To Freely Develop The Law Regarding Holder Claims And Whether Such Claims Can Be Brought As Class Actions

Because the lower federal courts have declined to exercise subject matter jurisdiction over such "holder" claims since *Blue Chip Stamps*, resolving whether such "holder" claims are valid under the common law is, quite obviously, a question that has been and must be left to the respective state courts. In those states where "holder" claims have already been recognized, individual actions should be allowed to proceed and, by definition, cannot and will not be preempted by SLUSA. As a result, large individual investors who have substantial "holder" damages (and, thus, can economically afford to bear the substantial costs involved in pursuing such fraud claims) will have appropriate state court forums to vindicate their "holder" claims. Smaller investors who have been similarly harmed, however, will not be able to vindicate their claims unless they have the opportunity to pursue them as class actions.

Under their broad police powers and in the absence of a clear intention by Congress to preempt such claims, the states' legitimate interest in determining whether and how to protect both large individual "holder" claimants and smaller claimants who may need to join together in a class action should remain intact. Moreover, there is no reason why the individual states should be precluded from determining whether "holder" claims, under the appropriate

circumstances, should proceed as class actions. To allow SLUSA to preempt "holder" class actions, on the other hand, would produce a perverse result. Large "holder" claimants would be allowed to pursue their claims in state court. Small "holder" claimants, to the extent that it would not be economical to bring their claims on an individual basis, would for all practical purposes be denied the opportunity for any relief whatsoever if such class actions were preempted under SLUSA.

Removal of state law based "holder" class actions would extinguish any right to pursue a class action for such claims because, under *Blue Chip Stamps*, holder claimants do not have standing under Section 10(b) of the 1934 Act. In contrast, small purchaser claimants whose state law claims can be brought as class actions under Section 10(b) do not have their right to pursue a class extinguished under SLUSA upon removal. They retain the right to pursue a class action under Section 10(b) if one has not already been brought. If a federal class action has already been brought, then at least their claims have the opportunity to be vindicated via a class action.

Thus, if SLUSA preempts their state law based class action, only small "holder" claimants are left with no opportunity to seek relief through the class action procedure. Yet, nothing in the language of SLUSA or in its legislative history indicates that Congress intended to completely extinguish the ability of any claimants to bring class actions, let alone "holder" claimants. Rather, Congress wanted to make sure that the practice of bringing state law based purchasers class actions to avoid the application of the PSLRA to claims that could have been brought under Section 10(b) would be governed by the PSLRA if the defendant chose to remove the action to

federal court. On this record, there is just no basis to justify the usurpation of what clearly is a state interest and state prerogative – the protection of smaller holder claimants who are defrauded and who, by definition, have no federal class action remedies.

Clearly, if such a result is to be achieved it can only be done pursuant to a clearly worded statute directed at this precise issue and not by an obtuse, convoluted misreading of the current statute as reflected in the Seventh Circuit's opinion in *Kircher*.

For this reason numerous courts have held that state law claims of misrepresentations or omissions that induce the plaintiff to retain stock can proceed in state court consistent with SLUSA. *See, e.g., Hardy v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 189 F. Supp. 2d 14, 18 (S.D.N.Y. 2001); *Dacey v. Morgan Stanley Dean Witter & Co.*, 263 F. Supp. 2d 706, 712 (S.D.N.Y. 2003); *Gutierrez v. Deloitte & Touche, L.L.P.*, 147 F. Supp. 2d 584, 595 (W.D.Tex. 2001); *Lalondriz v. U.S.A. Networks Inc.*, 68 F. Supp. 2d 285, 286 (S.D.N.Y. 1999); *Gordon v. Buntrock*, 2000 WL 556763, *4 (N.D. Ill. April 28, 2000); *see also Hines v. ESC Strategic Funds, Inc.*, 1999 WL 1705503, *6 (M.D.Tenn. Sept. 17, 1999) ("Because Plaintiff has alleged that the defendants' breach of their fiduciary duties resulted from their actions after she purchased her shares, Plaintiff's post-sale allegations are sufficient to withstand a motion to dismiss" based on SLUSA). As set forth below, there is good reason for this consensus.

IV. SLUSA Does Not Preempt State "Holder" Claims

It is through the prism of both the long history of judicial decisions interpreting the phrase "in connection with the purchase or sale of any security" as part of Rule 10b-5 jurisprudence and the purpose of SLUSA by which the phrase "in connection with the purchase or sale of a covered security" in SLUSA should be viewed. Although the starting point of statutory construction is the language of the statute itself, *Blue Chip Stamps*, 421 U.S. at 756 (Powell, J., concurring), the phrase in question was not written on a blank slate, but after decades of use and interpretation by this Court and lower federal courts. "[W]here Congress uses terms that have accumulated settled meaning under either equity or the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms." *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d at 1342 (11th Cir. 2002).

A. Purpose of PSLRA and SLUSA

In 1995, in response to perceived abuses of the federal securities laws through the filing of class actions of dubious or no merit, Congress passed the PSLRA. *See* Private Securities Litigation Reform Act of 1995, H.R. Conf. Rep. No. 104-369, *32 (Nov. 28, 1995), reprinted in 1995 U.S. Code Cong. Admin. News 730 ("the abuse of the discovery process [] impose[s] costs so burdensome that it is often economical for the victimized party to settle"). *See also Greebel v. FTP Software, Inc.*, 194 F.3d 185, 191 (1st Cir. 1999) (PSLRA passed to curb abuse in private securities lawsuits). In addition to enacting certain procedural

requirements concerning publication of the filing of an action and appointment of lead plaintiff, the PSLRA codified "loss causation" requirements, established a safe harbor for forward-looking statements, and raised the pleading requirement for the required state of mind. *See* 15 U.S.C. § 78u-4(b)(4) (codifying loss causation); 15 U.S.C. § 78u-5 (codifying safe harbor); 15 U.S.C. § 78u-4(b)(2) (codifying scienter requirements). The response of some defrauded investors was to file their purchaser cases in state court, thereby avoiding some of the PSLRA's more onerous requirements. In 1998 Congress enacted SLUSA in response to this perceived end run around the PSLRA. "Driving enactment of SLUSA was Congress' finding that litigants eluded PSLRA's reach with relative ease. Confronted with more onerous procedural requirements and dimmed prospects of success under the PSLRA, litigants simply abandoned use of federal courts and filed suit in state court under state securities laws." *Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 332 F.3d 116, 123 (2d Cir. 2003). Thus SLUSA's intended purpose was to ensure that actions which were actionable under federal securities laws would be brought in federal court and subject to the PSLRA's strict requirements.

B. Scope of Private Remedies Under Federal Securities Laws

A private cause of action under Section 10(b) of the 1934 Act, prior to the PSLRA, was an implied cause of action because private actions under Section 10(b) were not specifically authorized in the 1934 Act. *See Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995). As explained *supra*, this

changed in 1995 when the PSLRA codified certain elements of a cause of action under Section 10(b), including loss causation and scienter.

Since the contours of a private action under Section 10(b) were shaped by judicial opinions without the benefit of statutory guidance, the federal courts were left to decide issues such as standing on their own. In the decades that followed the 1930s and 1940s, the prevailing view on standing under Section 10(b) became the Second Circuit's opinion in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952). *Birnbaum* held that a plaintiff had to actually purchase or sell a security in order to satisfy the "in connection with" requirement of SEC Rule 10b-5. *Id.* at 463-64. In *Blue Chip Stamps*, this Court adopted the *Birnbaum* rule, holding that the "in connection with" requirement for a private action under Rule 10b-5 could only be met by a plaintiff who had actually purchased or sold the securities in question. *Blue Chip Stamps*, 421 U.S. at 754-55.

Blue Chip Stamps was premised on a balancing of the advantages and disadvantages of including non-purchasers and non-sellers within the ambit of protection under the implied cause of action under Section 10(b) of the 1934 Act.[7] The advantages of the restrictive *Birnbaum* rule were that it would eliminate what the Court perceived as speculative claims flooding the federal courts[8] –

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[7] In *Blue Chip Stamps* this Court found this balancing proper since private actions were a "judicial oak which ha[ve] grown from little more than a legislative acorn," and neither the 1934 Congress nor the SEC in 1942 anticipated the state of Rule 10b-5 in 1975. *Id.* at 737.

[8] This was particularly true for "[d]isappointed" purchaser claims where the gravamen of the claim would be that the frauds discouraged

(Continued on following page)

claims which would be harder to dispose of via pre-trial procedures because the claim might ultimately hinge on oral testimony concerning whether the plaintiff would have bought the stock. *Id.* at 742. By adopting the *Birnbaum* rule, this Court found that there would at least have to be some objective evidence regarding the fact that a purchase or sale took place. *Id.* at 747.[9] The disadvantage of the *Birnbaum* rule were that potential meritorious shareholder claims would be barred from the federal courts. *Id.* at 738-39.

C. The Second Circuit's Decision Is Correct

1. The Court Properly Considered Long-standing Interpretations Of "In Connection With"

It was proper and correct for the court below to consider the established meaning of "in connection with" when construing the parameters of SLUSA.

> In enacting SLUSA . . . Congress was not writing on a blank slate; instead it was legislating in an

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investors from purchasing a particular stock. This sort of claim could be manufactured based upon oral testimony any time a stock precipitously increased in value and would, quite obviously, present problems. In contrast, a "holder" claim is subject to objective evidence – a holder claimant actually owns the stock in question. The only issue that might be subject to oral testimony is whether the investor relied on the frauds. In cases not involving fraud on the market, investors must establish their reliance and this normally is accomplished through oral testimony.

[9] The same objective evidence exists for "holder" claimants – they own the stock and whether they owned it during the fraud period can also be objectively established.

> area that had engendered tremendous amounts of litigation and received substantial judicial attention . . . [Congress] was using language that, at the time of SLUSA's enactment, had acquired settled, and widely-acknowledged, meaning in the field of securities law, through years of judicial construction in the context of § 10b-5 lawsuits.

Riley, 292 F.3d at 1342-43. It is valid to assume that Congress, when it used the phrase "in connection with" in SLUSA, was using its accepted meaning in the federal securities laws. *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25, 36 (2d Cir. 2005); *Riley*, 292 F.3d at 1343. The circuit courts that have adopted this approach simply followed this Court's established precedent. "When . . . judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its . . . judicial interpretations as well." *Bragdon v. Abbott*, 524 U.S. 624, 645 (1998); *see also Lorillard v. Pons*, 434 U.S. 575, 581 (1978) (Congress can be presumed to have knowledge of interpretations of law incorporated into a new statute).

2. The Standing Rule of *Blue Chip Stamps* Is Properly Applied to SLUSA's "In Connection With" Language

In this case, the Second Circuit aptly stated:

> If the "in connection with" phrase is read to reach the same conduct under SLUSA as it does under § 10(b) and Rule 10b-5, then SLUSA will preempt precisely those state class actions which could be brought as federal actions subject to the

> heightened requirements of the PSLRA. If it were otherwise, actions might be preempted for meeting all of SLUSA's requirements, including the "in connection with" term, but not be capable of being brought under federal law for failure to meet the parallel requirement of Rule 10b-5, a result that the legislative history does not suggest Congress intended to produce in enacting SLUSA.

Dabit, 395 F.3d at 36. The *Dabit* court was absolutely correct in finding SLUSA was merely meant to preempt federal actions masquerading as state actions, and not meant to preempt state actions which never could be brought as federal actions.

The *Dabit* court correctly applied the *Blue Chip Stamps* standing rule. The Second Circuit reviewed the claims of two distinct class action plaintiffs, Shadi Dabit, a former Merrill Lynch broker; and IJG Investments Limited Partnership and Irlys Guy (collectively, "IJG"). *Id.* at 28-29. In the cases of both Dabit and IJG, the Second Circuit carefully examined each of the plaintiffs' claims for any allegation that was "in connection with" or "coincided with" a security transaction, and where it found that the allegation included a transaction that fell within the *Blue Chip Stamps* rule, that claim was dismissed as preempted under SLUSA.

3. SLUSA Does Not Completely Preempt All State Class Actions Which Might Involve Publicly Traded Securities

This Court has held that "in deciding if federal law preempts state law . . . we start with the assumption that the historic police powers of the States were not to be

superseded by the Federal Act unless that was the clear and manifest purpose of Congress." *City of Milwaukee v. States of Illinois and Michigan*, 451 U.S. 304, 316 (1981). The express language of SLUSA does not provide that all state actions involving publicly traded securities are preempted. In fact, it states just the opposite namely, that it is intended to "prevent *certain* State private securities class action lawsuits alleging fraud from being used to frustrate the objectives" of the PSLRA, Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (emphasis added). Because the objectives of the PSLRA concerned only federal securities lawsuits permitted under the *Blue Chip Stamps* rule, other state private actions which historically were excluded from the ambit of Section 10(b) could not possibly have been the target. Further, there is nothing in the legislative history of SLUSA to indicate that was Congress' intent.

The conference report states the purpose of SLUSA is "to prevent plaintiffs from seeking to evade the protections that Federal law provides against abusive litigation by filing suit in State, rather than in Federal, court." Securities Litigation Uniform Standards Act of 1998, H.R. Conf. Rep. No. 105-803, at 13, 1998 WL 703964 (Oct. 9, 1998). The protection federal law provided against supposedly abusive litigation were the procedural and pleading requirements imposed by the PSLRA, which only applied to lawsuits which could be filed in federal court in the first instance. Thus there is no support either in the text of the statute or the legislative history of SLUSA for a finding that it preempts every possible state class action involving publicly traded securities, including those which could never have been filed in a federal court.

V. The Seventh Circuit's Decision In *Kircher* Is Premised On Faulty Assumptions

In *Kircher*, the Seventh Circuit misinterpreted *Blue Chip Stamps* and SLUSA and it therefore reached the incorrect decision when it held that "holders" claims satisfied the "in connection with" requirement of SLUSA and were preempted. *Kircher* contained a lengthy discussion of *Blue Chip Stamps* and how the decision reflected a policy decision to limit private causes of action to actual purchasers or sellers. 405 F.3d at 482-83. However, *Kircher* went awry when it stated:

> It would be more than a little strange if the Supreme Court's decision to block private litigation by non-traders became the opening by which that very litigation could be pursued under state law, despite the judgment of Congress (reflected in SLUSA) that securities class actions must proceed under federal securities law or not at all.

Id. at 484. This holding reflects a misunderstanding of both SLUSA and *Blue Chip Stamps*. As explained *supra*, SLUSA was passed to ensure that actions which are subject to the federal securities laws are filed in federal court, subject to the rigors of the PSLRA, and not under parallel state provisions. It was not meant to ensure that, as *Kircher* stated "securities class actions must proceed under federal securities laws or not at all." Moreover, while the *Blue Chip Stamps* court did block private litigation by non-traders, it did so only in federal court under the federal securities laws, and only because, *inter alia*, those non-traders could pursue remedies under state law. *Blue Chip Stamps*, 421 U.S. at 739 n.9. It would be "more

than a little strange" *not* to allow these purely state cases to be pursued in state court, especially when it was the judgment of Congress simply not to allow federal cases to be filed in state court. There is no evidence Congress meant to preempt claims which never could have been filed in federal court in the first place.

CONCLUSION

Accordingly, NASCAT and AARP respectfully request this Court affirm the decision of the Second Circuit in this matter.

Respectfully submitted,

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December 16, 2005

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS COUNTY DEPARTMENT - CHANCERY DIVISION

MICHAEL DLOOGATCH, on behalf of himself and all others similarly situated, Plaintiff, v. JOHN N. BRINCAT, JOHN N. BRINCAT, JR., WILLIAM C. CROFT, MERCURY FINANCE COMPANY, and KPMG PEAT MARWICK, Defendants.	No. 97 CH 8790 Judge Patrick E. McGann Cal. 6

MEMORANDUM OPINION AND ORDER

Plaintiff Michael Dloogatch, on behalf of himself and all others similarly situated, moves, pursuant to Section 2-801 of the Illinois Code of Civil Procedure, 735 ILLS 5/2-801, to certify a class of "people who owned the common stock of Mercury Finance Company on or before February 23, 1994 and held their stock through and including January 29, 1997." Defendant KPMG Peat Marwick ("KPMG") objects to class certification with respect to each of Section 2-801's requirements.

I. FACTS

Plaintiff Michael Dloogatch ("Plaintiff" or "Dloogatch") has entered into a class-wide settlement agreement with Mercury Finance Company ("Mercury") and the individual defendants. KPMG, who acted as Mercury's accounting

firm and independent auditor of its financial statements, is the only remaining defendant in this cause. In the complaint, plaintiff seeks recovery against KPMG for negligence, negligent misrepresentation and common law fraud, claiming that during the period from February 23, 1994 through January 29, 1997, KPMG issued to the class members, all of whom were shareholders in Mercury, false and misleading auditor's letters certifying the accuracy of Mercury's financial statements that falsely portrayed Mercury's revenues, earnings and financial condition.

Plaintiff seeks to certify a class of holders of Mercury stock that owned Mercury stock on the last day before the fraud began, February 23, 1994, and who held their stock during the three-year period when the fraud was revealed on January 29, 1997. On January 29, 1997, Mercury announced that previously reported net income for the fiscal years 1993 through 1996 would be restated due to the discovery of accounting irregularities. According to the plaintiff, those false and misleading financial statements and auditor's letters misled the holders into believing that Mercury was a going concern with a bright future, only to experience substantial losses when the truth about Mercury's poor financial condition was disclosed on January 29, 1997. The plaintiff claims that he and the remaining members of the proposed class would not have held onto the stock, if not for the false reported earnings and auditor's letters.

Plaintiff has defined the class as:

> All persons who purchased common stock of Mercury Finance Company prior to February 23, 1994 and held such stock through and including January 29, 1997. Excluded are KPMG and any entity which KPMG has a controlling interest or

which is a parent or subsidiary of or is controlled by KPMG, and the officers, directors, employees, affiliates, legal representatives, heirs, successors and assigns of KPMG.

II. DISCUSSION

Section 2-801 of the Illinois Code of Civil Procedure, 735 ILCS 5/2-801, provides for the maintenance of a class action in Illinois. Under this section, the court must find that: (1) the class is so numerous that joinder of all members is impracticable; (2) there are questions of fact or law common to the class, which common questions predominate over any questions affecting only individual members; (3) the representative parties will fairly and adequately protect the interest of the class; and (4) the class action is an appropriate method for the fair and efficient adjudication of the controversy.

In deciding whether to certify a class, a court may consider "any matters of fact or law properly presented by the record, including the pleadings, depositions, affidavits, answers to interrogatories and any evidence that may have been adduced at the hearings." *Charles Hester Enterprises, Inc. v. Illinois Founders Insurance Co.*, 137 Ill. App. 3d 84, 100 (5th Dist. 1985). This decision is left to the sound discretion of the trial judge and will be disturbed only upon a finding of a clear abuse of discretion or the application of impermissible legal criteria. *Slimack v. County Life Insurance Co.*, 227 Ill. App 3d 287, 292. (5th Dist. 1992).

1. Numerosity

The numerosity portion of the Illinois statute is identical to the language found in Rule 23 of the Federal Rule of Civil Procedure. Thus, decisions of the federal courts on this issue are instructive. *Wood River Area Development Corp. v. Germania Federal Savings and Loan,* 198 Ill. App. 3d 445, 450 (5th Dist. 1990).

Although the easiest factor to find, the issue as to whether the proposed class is large enough to make joinder of all members impracticable is not subject to arithmetic certainty and depends on the facts and circumstances of each case. In *Wood River,* the Appellate Court noted that courts, either federal or state, have not established a "magic number" which guarantees certification. The court did, however, point with authority to a quote from Miller, *An Overview of Federal Class Actions: Past, Present and Future*, Federal Judicial Center, at 22 (1977), which stated:

> If the class has more than forty people in it, numerosity is satisfied; if the class has less than twenty-five people in it, numerosity is probably lacking; if the class has between twenty-five and forty, there is no automatic rule and other factors . . . become relevant,

In *Wood River*, where there was twenty-one potential class members, reduced to eighteen after three opted out, the Court held that because the size was relatively small, additional reasons for the use of the class action procedural device was appropriate. These additional factors are: (1) the class members geographical distribution; (2) the ability to identify and locate the class members; (3) the degree of knowledge and sophistication of the class members and

their need for protection; (4) the amount of claims of the individual class members; and (5) the nature of the cause of action. *Wood River*, 198 Ill. App. 3d at 451.

Dloogatch asserts that he has met this numerosity requirement, using as an example that over 1000 class members have filed valid claims for their share of the settlement of claims against the other defendants in this matter. KPMG claims that Dloogatch cannot meet the numerosity requirement because there is a strong reason to believe that many of the class members who sought compensation against other defendants have since released any claims they had against KPMG. Specifically, KPMG argues that since two classes of purchasers of Mercury securities have released their claims against KPMG in a federal case, all putative members of the holder class who also purchased Mercury securities during the class period and have not opted out of the purchaser class, have released their claims and cannot be members of the holder class. KPMG points out that 53 of 61 institutional investors had purchased stock during the class period, and have thus, released their claims against KPMG. KPMG also argues that at least 14 individual plaintiffs have asserted individual claims against KPMG and are in a position to assert their rights without relying on the class action device. The Plaintiff denies the effect of the releases.

Here, KPMG is correct that certain potential class members may have released their claims against certain holders but its argument ignores the fact that at least some holders were not also purchasers during the class period. The releases executed as part of the previous settlement, Exhibit 5 to Defendant's Memorandum, appear to affect only those persons who purchased Mercury stock

on and after April 10, 1995 and up to and including January 29, 1997. The document also absolves KPMG of liability for any and all services they performed for Mercury during that time period. On its face, the settlement agreement appears to exclude any putative member of the "holder class" who purchased additional shares of Mercury stock during the applicable period. It does not impact on those investors, who purchased the stock prior to February 1994 and held the stock until January, 1996. The exact number of individuals in either category is not left to speculation. Mercury was an actively traded security. More than thirty thousand notices were mailed in connection with a previous settlement. A number of institutional investors did not settle their claims. In addition, the defendant's expert, Mr. Cox' statistics suggest a significant amount of ownership retention in his analysis of Mercury's trading volume at the time of the financial reports.

In addition, the Plaintiff's suggestion that there are at least one hundred thirty members of the proposed class is persuasive. The defendant's arguments and illustrations are not sufficient to defeat the plaintiff's assertion that those holders meet the numerosity requirement, because the numerosity requirement generally requires only about forty class members. If the Plaintiff's class is as small as the defendant suggests, the issues relating to the predominance of common questions of reliance may not be as cumbersome as suggested. Therefore, the plaintiff has met the numerosity requirement.

2. Common Questions of Law or Fact.

Prior to the enactment of Illinois' class action statute, common law required that a party seeking to be a representative in a class suit have a community of interest in the subject matter and the remedy. *Harrison Sheet Steel Co. v. Lyons*, 15 Ill. 2d 532, 537 (1959). This standard precluded a party opposed to the class from interposing an objection by asserting hypothetical versions of a minor character to prevent use of the class suit procedure. *Lyons*, 15 Ill. 2d at 538.

Shortly after Section 2-801 was enacted, then codified as SHA Ch. 110 § 57.2, the Supreme Court issued its decision in *Steinberg v. Chicago Medical School*, 69 Ill. 2d 320 (1977). The plaintiff, Robert Steinberg, had applied for admission and paid the required fee to the defendant medical school based upon its promise to make acceptance decisions upon the criteria stated in its catalog. This booklet emphasized academic achievement and potential as the primary factors considered for admission. He alleged that unbeknownst to him and others similarly situated a candidate's chance of acceptance increased in direct proportion to the contribution or pledge of contribution to the school's endowment fund. After finding the former "community of interest" standard lacked structure, the Court set forth the simple test of finding common questions of law or fact. It also recognized that slight deviations of claims by some portion of the class will not in and of itself serve to defeat certification. *Steinberg*, 69 Ill. 2d at 338.

As recognized by *Steinberg*, the standard now set out by the legislature requires the court to perform a two-step analysis. First, the court must ask whether there are

common questions of law or fact. The language is in the disjunctive; therefore, the commonality can be in fact or law. If there are common questions of law or fact, the trial court must determine whether the common questions predominate over questions involving individual members.

In this case, Dloogatch asserts that the common question of law or fact is whether KPMG is liable for its conduct in auditing Mercury and disseminating the audit opinion letters, and also claims that it is appropriate to prove the class' actual reliance through circumstantial evidence sufficient to create an inference of reliance. This is a reasonable position as corporate financial statements are distributed to shareholders with an invitation they be read and relied upon.

The Supreme Court of California has recently noted the importance of the need for integrity in our financial markets. The financial hardships reported in our daily papers caused by shoddy or unethical business practices shielded by inadequate or corrupt oversight by outside auditors affect every resident of this country either directly by a loss of wealth or indirectly by increased costs imposed because risk cannot be accurately gauged. see *Small v. Fritz Companies*, 30 Cal. 4th 167 (2003). Thus, the role of KPMG in preparing the audit letters and other financial reports which the Plaintiff alleges caused his loss is a critical issue in this litigation.

KPMG argues that the highly individualized question of reliance is the predominant issue in this case. KPMG additionally objects that plaintiff's class-wide theory of damages do not present predominant common issues because case law rejects plaintiff's benefit of the bargain

theory of damages because holders cannot claim the benefit of any bargain.

The Court accepts for the purpose of this motion that the audit and financial reports prepared by KPMG and distributed to shareholders by Mercury, served to a very great extent, to set the market price of the stock. It also must be assumed that the stock price was artificially inflated by the fraudulent financial statements. The Court acknowledges KPMG's strong denial of any wrongdoing. As noted, the statements were distributed to furnish information to the shareholders and others either making or advising on investment decisions. The gravamen of fraud and negligent misrepresentation is reliance on the falsehood. That means the injured party must do something as a result. That can be either action or, as alleged in this case, inaction. *Wright v. Chicago Title Insurance Co.*, 196 Ill. App. 3d 920, 926 (1990). KPMG posits that if the requirement of actual reliance were relaxed, individuals who never read the reports or relied solely on the market in making decisions to buy, sell or hold securities would have a claim. This would unjustifiably expose KPMG to potential liability for unsubstantiated claims and be inconsistent with the rule set down in *Oliveira v. Amoco Oil*, 201 Ill. 2d 134 (2002).

The danger of non-meritorious suits in securities cases has been recognized by the United States Congress with the enactment of the Private Litigation Securities Act of 1995 (109 Stat. 737). The United States Supreme Court also noted sensitivity to the issue of fraudulent claims in barring "Holders Actions" under federal securities laws *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739-740, 743-747 (1975). In a stated effort to reduce the potential of such suits, one state court now requires that a

Plaintiff making a state claim for fraud on a theory of "Holding" stock must allege with particularity "how, when, where to whom and by what means the representations were tendered as well as details concerning the abandoned decision to sell the security in question. *Small v. Fritz Companies, Inc.*, 30 Cal. 4th 167, 184 (2003). Claims for negligent misrepresentation must allege that if the true financial status were known, a sale would have occurred, how much stock would have been sold, and when the sale would have occurred. Id. The focus in each claim, the Court noted, was on the decision making process of the alleged injured party.

Plaintiff Dloogatch has asserted claims of common law fraud, negligence and negligent misrepresentation against KPMG. In order to state a claim for common law fraud or negligent misrepresentation, the plaintiff and all of the individual class members must prove justifiable reliance upon the truth of the misrepresentations. *Chicago v. Michigan Beach Housing Coop.*, 297 Ill. App. 3d 317, 323 (1st Dist. 1998); *Good v. Zenith Electronics Co.* 751 F. Supp. 1320, 1323 (N.D. 1990) (applying Illinois law); *In re First Merchants Acceptance Corporation Securities Litigation*, 1998 WL 781118 at 12 (N.D. Ill.) (applying Illinois law). Similar to *Fritz Companies*, the focus in these claims must be on the decision making process of the Plaintiffs.

Other courts considering such claims have rejected them as too speculative *Chanoff v. United States Surgical Corp.*, 857 F. Supp. 1011 (D. Conn. 1994) or required personal contact between the defendant and plaintiff as well as extrinsic proof. *Guthman v. Howard Savings Bank*, 748 F. Supp. 254 (D. N.J. 1990).

The plaintiff seeks to assert an inference of reliance, although he claims that he is not relying on the fraud on the market theory. The fraud on the market theory, used in securities fraud cases brought under Rule 10b-5 of the Securities Exchange Act of 1934, allows for a rebuttable presumption of reliance that a person purchasing stock relied on the integrity of the price as set by the market and that a misleading statement or omission by defendants resulted in a lower stock price. *Good*, 751 F. Supp. at 1323, citing *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). This presumption has been used to satisfy the plaintiff's requirement to plead and prove transaction causation. Plaintiffs most likely cannot rely on the fraud on the market theory because several courts have held that while the theory applies to securities fraud litigation, the theory does not apply to state common law actions for fraud and negligent misrepresentation. *Good*, 751 F. Supp. at 1323; *Katz v. Comdisco*, 117 F.R.D. 403, 412 (ND. Ill. 1987). Moreover, the Illinois Supreme Court has recently rejected the theory's application to a claim under the Illinois Consumer Fraud Act. *Oliveira v. Amoco Oil Co.*, 201 Ill. 2d 134 (2002). The Court required such plaintiffs to show the injury was proximately caused by the acts of consumer fraud. It is important to note that the Supreme Court's decision expressed a concern that the use of the fraud on the market theory would allow individuals who did not hear or believe the admittedly false advertising to recover unjustly.

Dloogatch's position is a variation of a theory found in the earlier cases authorizing a "holder's claim" in securities litigation. In *Continental Insurance Company v. Mercandante*, 225 N.Y.S. 488 (S. Ct. App. Div. 1927), the court was called upon to determine if a claim for fraud

could be stated where the plaintiff insurance companies did not allege that the defendant's fraud did not cause the plaintiffs to change their decision to sell the securities. Rather, the wrong occurred when the misrepresentation "transmuted their indecision whether to sell or keep into a damaging decision to retain." The court noted that the plaintiffs had acted in a manner suggested by the misstatements, retain the security as a valuable investment. This the court held showed, at the pleading stage, *prima facie* legal causation. The court reasoned the question was not whether the deceived party would have lost had the fraud not been practiced, but whether there was a reasonable probability that the fraud actually accomplished the result it was intended to bring about. Here, the allegations in the complaint set forth a series of deliberate acts done by KPMG which were intended to influence investor decisions related to purchase, sale, or retention of stock in Mercury Finance Company.

Subsequent to the *Mercandante* decision, the Congress enacted the depression era securities laws. The rights of investors under these statutes were the focus of fraud litigation over the ensuing four decades. While state fraud claims were prosecuted, they were usually pendant to the predominant action under section 10b of the Securities Exchange Act of 1934. The law that developed under that scheme required a plaintiff to establish loss causation as well as transaction causation in order to successfully prosecute the action. *AUSA Life Insurance Company v. Ernst and Young*, 206 F3d. 202, 209 (2nd Cir. 2000). Loss causation is causation as defined in the traditional proximate cause sense. Id. Transaction causation on the other hand has been analogized to reliance because it means the violations in question caused the [injured party] to engage

in the transaction in question. Id. However, in a securities fraud case these two theories coalesce if the plaintiff can establish that the transaction would not have occurred but for the misrepresentation and that the misrepresentation created the disparity between the price and the "investment quality" of the security at the time of the transaction. *Castellano v. Young & Rubicam, Inc.*, 257 F.3d. 171, 187 (2nd Cir. 2001).

It necessarily follows, that if the *Mercantante* rule were accepted by this Court, a fact finder would be allowed to conclude that KPMG's alleged wrongdoing caused the market to react in reliance on their reports. Such a decision would run afoul of the Supreme Court's admonition against use of the market theory to establish causation.

As the plaintiff argues, it is true that the Illinois Supreme Court in *Steinberg* stated that having "one count based on fraud does not prohibit a class action." *Steinberg*, 69 Ill. 2d at 340. In understanding the import of that statement and the Court's reference to *Korn v. Franchard Corp.*, 456 F.2d 1206 (2nd Cir. 1972) (Claim for violation of securities law in sale of a limited partnership interest), the facts in Steinberg are instructive as is an analysis of Illinois law evolving after Korn.

In Steinberg, it was clear that the Court had found the defendant medical school had an equitable duty of disclosure to the applicants. The Court also noted the conflict in then existing Illinois case law as to this issue and finally suggested the trial court had certain options, such as subclasses or following the suggestions in *Korn*. It is also important to remember that in *Steinberg*, there were breach of contract and consumer fraud counts where reliance on the falsehood is not an element.

This Court accepts the principal that individual issues of reliance will not prevent certification. This is especially true where a common core of facts exist or other claims are joined and where reliance is neither presumed nor an element of the claim. See *Arenson v. Whitehall Convalescent and Nursing Home, Inc.*, (164 F.R.D. 659 ND Il. 1996) (overcharging patients for medication alleged to be fraud, consumer fraud, and RICO violation); *Eisenberg v. Gagnon*, 766 F. 2d 770 (3rd Cir. 1985) (common offering of sale of worthless tax shelters); *Green v. Wolf v. Wolf* Corporation, 406 F.2d 291 (2nd Cir. 1968) (sale of stock based on three prospectuses containing similar false representations); *In re Activision Securities Litigation*, 621 F. Supp. 415 (ND Cal. 1985) (sale of stock based on false prospectus, court allowed certification of state fraud claim joined with 10b-5 action certified without objection by defendant). The other cases cited by the Plaintiff also involve claims of fraud in the sale of securities or insurance based upon false sales material uniformly distributed.

The courts of Illinois have not adopted any of the suggestions found in *Korn*. The Plaintiff has not cited to one case where the traditional elements of a fraud claim has been relaxed by a court. Indeed, as noted, the Supreme Court recently reinforced the necessary requirement of pleading and proving proximate cause in these cases. See *Oliveira*, 201 Ill. 2d at 155.

Hence, this Court concludes there are significant individual questions related to the issue of reliance. This Court, however, must examine whether the individual questions of reliance in the instant case will predominate over the common questions of law or facts in the instant case. In undertaking this analysis, the Court is mindful of the important role the class action has played in protecting

individual investors from securities fraud. In order to make his claim, the Plaintiff must prove that KPMG knowingly made a false statement concerning the financial status of Mercury Financial. That the statement was made with the intent that investors rely upon it, that reliance occurred because the injured party had a right to rely on the falsehood. Finally, that damage was proximately caused by the reliance. *Siegel v Levy Organization Development Company, Inc.*, 153 Ill. 2d 534, 542-543 (1992). The determination of KPMG's role in auditing the financial records of Mercury will determine whether it knowingly made a false statement with the intent that investors rely on it. This would create a core set of facts upon which, if necessary, individual class members can present claims of reliance. The resolution of these issues, in this Court's judgment, predominates over all others. The determination of this core issue would relieve this Court and those small investors of the cost of multiple investigations and trials over that portion of the case. KPMG would avoid the multiple defense costs necessitated by multiple filings. Moreover, if the class is as small as suggested by KPMG, the later portion of the proceedings will be not burdensome at all. Common sets of interrogatories and other discovery tools can be devised. An administrative process designed to separate valid claims from those without merit can be employed. Thus necessitating trials in only the former cases.

This Court acknowledges that several federal and foreign state courts have denied class certification as to the state law claims on the basis that individual issues of reliance would predominate over any common question of fraud and negligent misrepresentation. *Katz*, 117 F.R.D. at 412; *Good*, 751 F.Supp. at 1323; *Gaffin v. Teledyne*, 611

A.2d 467, 474 (Del. 1992) (questions as to the element of justifiable reliance will inevitably predominate over common questions of law or fact). The notice provision of the Code of Civil Procedure (735 ILCS 5/ 2-803), unlike that of Rule 23 of the Federal Rules of Civil Procedure places no restriction on requiring certain information from putative class members to make a claim or become a member of the class. Information concerning decisions to hold the security and the basis of those decisions can be required and reviewed for sufficiency. If facially defective, they can be summarily rejected. If the proper claim is made, KPMG can pose the agreed upon interrogatories, engage in limited document production and depose the claimant, as well as, insist on an individual hearing to contest the claim. That trial however will be limited solely to the issues of reliance and damages. This procedure would not be unlike those employed in other mass tort cases. It is not unusual for courts to conduct a single trial in crash-related or toxic mass torts on limited issues. Once liability is established, individual trials are conducted on issues related to causation and damages. *Conte, Newberg, Newberg on Class Actions* Chapter 17 generally and Section 17.28 (4th Edition, Thomson/West 2002).

On the other hand if the responding class is too large, the court can decertify the class and allow the claimants to proceed individually with a binding finding of KPMG's wrongdoing as the benefit of class membership.

In addition, while Dloogatch's expert, Dr. Lewellen has asserted a benefit of the bargain calculation of damages, calculating the damages owed to all of the holders as the difference between the value of Mercury stock on the day before the fraud was revealed and the price after the fraud was revealed. KPMG argues that any theory of

damages which applies equally to all shareholders is a shareholder derivative claim, and must be pleaded as such. Moreover, KPMG asserts that this is not a benefit of the bargain case, because all class members purchased their Mercury stock before any fraud occurred and the need to subtract any gains from the alleged fraud presents a predominant individual issue that undermines any effort to calculate damages on a class-wide basis.

Plaintiff is correct that this Court need not determine the proper measure of damages at this instant, however, in Illinois the benefit of the bargain approach generally assesses the difference between the actual value of the property purchased and the value of the property had the representations been true. *Gerill Co. v. Jack L. Hargrove Builders*, 128 Ill. 2d 179, 196 (1989); *Giammanco v. Giammanco*, 253 Ill. App. 3d 750, 759 (2d Dist. 1993). In this case, it is unclear how the benefit of the bargain approach would be appropriate in determining the damages of individuals who purchased the stock before any fraud occurred and held this stock throughout the fraud. The price paid for the security was the value set by the market thus they received full value for their money. They held the stock for the entire period of the fraud and suffered damage once the truth was revealed. No claimant can receive any benefit from the inflated price as they would be profiting from a fraud. Thus it appears the benefit of the bargain approach would have no application. Moreover some class members may have sold the stock precipitously and received an artificially depressed price. The defendant's suggestion that any loss incurred must be offset by any gain received for stock sold during the fraud has significant equitable appeal. Finally, the Court in *Small v. Fritz Company*, supra. discussed many approaches to the

determination of damages which this Court finds of interest. Nevertheless, this Court need not determine the proper measure of damages, but notes benefit of the bargain damages appears to be an inappropriate measure.

The final point on this issue is whether the claims are personal or derivative. In order to make such a determination, the Court must determine the nature of the harm and the relief available upon success of the suit. In order to state a direct claim under Delaware law, the plaintiff must establish that the injury was one that is different than that suffered by the other shareholders or involves the contractual rights of the shareholder that are independent of the corporation's rights. *Kramer v. Western Pacific Industries. Inc.*, 546 A. 2d 348, 351 (Del. 1988). This determination is made from a review of the actual claims in the complaint, not its captions or stated intentions. Id. P. 352. Here, the Plaintiff's [sic] allege an injury that is separate from any injury to the corporation. The injury is not related to corporate affairs or to their rights as shareholders. Their injury is personal to each of them. As the Defendant so eloquently argued each shareholder's loss or damage is unique to him or her. There is no commonality. Their rights do not derive from those of the corporation. Their injury, if any, derives from their right to purchase securities in a free, open and honest market. This right was violated, they allege, by the intentional acts of KPMG. The Defendant vigorously denies the allegations and so the issue is joined.

3. Adequate Representation

This requirement has due process implications. In order to determine adequacy of representation, the trial

judge must examine two issues: (1) will representation by the proposed class representative protect the members of the class who must be afforded due process; and (2) does the attorney have the skill, qualifications and experience to conduct the proposed litigation? *Steinberg*, 69 Ill. 2d at 339.

A. Adequate Representation by Proposed Representative

Unlike the requirement in Rule 23 of the Federal Rules of Civil Procedure that the claim of the proposed class representative be typical of those of the class, Illinois has adopted a more liberal approach. *Carrao v. Health Care Service Corp.*, 118 Ill. App. 3d 417 (1st Dist. 1983). In Illinois, the class representative must fairly, adequately and efficiently represent absent class members. *Gordon v. Boden*, 224 Ill. App. 3d 195, 203 (1st Dist. 1991).

This has been defined as showing the interest of the proposed class representatives are not antagonistic to those of the absent class members. Thus, issues such as slight variations in the claim, *Purcell Wardrope Chtd. v. Hertz Corp.*, 175 Ill. App. 3d 1069, 1078 (1st Dist. 1975), or individualized affirmative defenses, *Wenhold v. AT & T*, 142 Ill. App. 3d 612, 619 (1st Dist. 1986) will not defeat certification. However, in cases where there is evidence of antagonism or collusion, *Hansberg v. Lee*, 311 U.S. 32 (1940), between the proposed representative and absent class members or a close connection with the lawyer representing the proposed class, *Barliant v. Follett Corporation*, 74 Ill. 2d 266 (1978), class certification should be scrutinized.

In this case, KPMG argues that Dloogatch will not adequately represent the interests of the class because he is subject to a defense that he cannot prove that he relied on any fraudulent statement because he did not sell the stock even after the alleged fraud was revealed in January 1997 and if Dloogatch intends to rely on its alternative theory of damages, opportunity cost, he is a poor representative. These individualized affirmative defenses, which can be explained by deposition testimony, are not sufficient to undermine Mr. Dloogatch's ability to adequately represent the class.

B. Adequacy of Representation by Counsel

KPMG does not assert that counsel will not adequately represent the potential class. Moreover, this Court has read pleadings submitted by counsel and has determined that counsel will adequately represent the class.

For these reasons, the adequate representation prong is met.

3. Appropriate Method for Fair and Efficient Adjudication

In its earliest explanation of this prong, the Supreme Court noted that once a determination was made that a question of law or fact common to the class predominates, the statute is satisfied. *Steinberg v. Chicago Medical School*, 69 Ill. 2d 320, 340-341 (1977). The court noted that once the dominant issue was resolved, the trial judge could employ various procedures to resolve issues that affect some, but not all of the class members. This could include breaking the class into identifiable subgroups or even ordering individual trials.

Later cases developed a two-pronged test to determine whether this requirement was met. Satisfaction of either test proves the statutory requirement. The test is whether: (1) the class action procedure can best secure the economics of time, effort and promote uniformity; or (2) accomplish the other ends of equity and justice that class actions seek to obtain. Furthermore, a controlling factor in many cases is that the class action is the only practical means for class members to receive redress, particularly where claims are small. *Gordon*, 224 Ill. App. 3d at 204-205.

This case is an appropriate method for the fair and efficient adjudication of the individual class issues. While the class action vehicle is not the only practical method for the class members to receive redress. As KPMG pointed out, numerous individual holder actions have been filed against it. There are, as noted, efficiencies to be gained from proceeding as a class action. The investigation into the relationship between KPMG and Mercury will be costly and time consuming. It will require extensive document production, multiple depositions and the use of expert witnesses. Individual investors probably do not have the ability or resources to undertake such a task. The class action vehicle was designed for this type of case.

Hence, the Court concludes the Plaintiff has established the requirements for Class Certification.

III. ORDER

A. This Court certifies as a class of Plaintiffs:

> All persons who purchased common stock of Mercury Finance Company prior to February 23, 1994 and held such stock through and including January 29, 1997. Excluded

are KPMG and any entity which KPMG has a controlling interest or which is a parent or subsidiary of or is controlled by KPMG, and the officers, directors, employees, affiliates, legal representatives, heirs, successors and assigns of KPMG.

B. The matter is set for case management conference to discuss, among other issues, the form and content of the notice to the certified class on 8/18, 2003, at 11:30 A.M.

JUDGE

DATED:_____ ENTERED: PATRICK McGANN – 1510
Judge 1510

No. 04-1371

FILED
DEC 19 2005
OFFICE OF THE CLERK
SUPREME COURT, U.S.

IN THE

Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Petitioner,

v.

SHADI DABIT, on behalf of himself and all others similarly situated,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF NEW YORK, CALIFORNIA, CONNECTICUT, HAWAII, ILLINOIS, IOWA, MICHIGAN, MINNESOTA, MISSISSIPPI, MONTANA, NEW JERSEY, NEW MEXICO, OHIO, OKLAHOMA, OREGON, SOUTH CAROLINA, VERMONT, WASHINGTON, WISCONSIN AS *AMICI CURIAE* IN SUPPORT OF RESPONDENT

CAITLIN J. HALLIGAN*
Solicitor General

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QUESTION PRESENTED

Whether SLUSA preempts state-law claims brought by holders of securities based upon misrepresentations, omissions, or manipulation.

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INTERESTS OF AMICI CURIAE

Amici States urge the Court to affirm the decision of the United States Court of Appeals for the Second Circuit in *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, holding that the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), Pub. L. No. 105-353, 112 Stat. 3227, does not preempt state-law class-action claims brought solely on behalf of persons who were fraudulently induced to hold or retain securities.

Amici States have a legitimate and compelling interest in preserving a business climate free from fraud and deceptive practices, and have used their police powers to achieve this goal for more than a century. In general, state-law private rights of action have been an important means of compensating victims of securities fraud and compelling compliance with securities laws. More specifically, state law has long provided remedies to investors fraudulently induced to hold or retain a security, *see, e.g., Duffy v. Smith*, 32 A. 371 (N.J. 1895), and, since 1975, state law has provided the *only* remedy for such investors, *see Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

SLUSA displaces this historic exercise of the States' police power, thereby disrupting the balance of state and federal power that has long operated in the securities arena. For this reason, this Court's precedent dictates, and Amici States strongly agree, that the scope of SLUSA's preemption must be strictly limited to those causes of action that Congress explicitly intended to preempt: actions "in connection with the purchase or sale of a . . . security," a phrase which has previously been defined by this Court in *Blue Chip Stamps* to exclude private actions brought by nonpurchasers or nonsellers. Thus, SLUSA cannot be construed as displacing state-law causes of action for holder claims. To hold otherwise would eliminate remedies long available to injured investors, and strip States of essential authority to protect their citizens from fraud in securities transactions.